## I. Introduction/ Executive Summary

On May 12, 2000, the Department of Telecommunications and Energy (Department) issued an Order in D.T.E 99-60-A introducing a proposal to address certain "essential components" associated with the pricing and procurement of default service. On May 25, 2000, the Department held a technical conference to discuss various issues raised by the Department's Order of May 12, 2000. The Department also requested written comments from interested parties on the questions and issues raised in the Department's Order and at the technical conference.

The Division of Energy Resources ("DOER") wishes to address some of the questions posed by the Department in its Order and make the following recommendations:

The Department should recognize that establishing appropriate levels of administrative and other costs for inclusion in default service rates is as much a matter of policy as of precision. This can be readily accomplished outside of a base rate proceeding.

The Department should focus its efforts on establishing rates for default service that are reasonable. In the long run, the distribution companies should reduce their distribution rates for all costs that they can avoid when customers depart from default service to receive generation service from competitive suppliers.

The Department should announce its intent to implement class-specific solicitations and pricing for default services.

The Department should direct the distribution companies to make an initial effort to identify and estimate the cost components of the default service rate beyond those implicit in anticipated bid prices from default service generation suppliers.

In the short run, the Department should implement a credit mechanism to ensure that distribution companies do not reap a windfall associated with default service revenues above any new costs incurred to provide the service.

The Department should oversee default service supply solicitations to ensure that they are conducted in a manner that is likely to minimize costs to customers, and to maximize the likelihood that default service generation supplies are available when needed.

## II. Responses to Questions:

**Question 1: Are there data that demonstrates that the costs associated with providing default service will differ significantly among customer classes? If so, please provide a full description of such data and discuss the manner in which customer classes can or should be differentiated for the purpose of establishing different default service prices. Would such differentiation be consistent with or offensive to the statutory scheme for restructuring the electric industry?**

During the Default Service technical session held on Thursday, May 25, all parties that commented on this question, including the distribution companies, readily acknowledged that there are different costs to serve different rate classes. This fact has been fully documented for many years. Such attributes as load shapes and load factors differ markedly by customer class, and the cost to provide them power differs accordingly. Certain types of customers will more readily move between the market and Default depending on their ability to do so and the various current market conditions and the options that are (or are not) available to them.

All of these factors (and more) will differentiate the risks that wholesalers bear in providing all requirements supply for different classes of Default Service customers. These risks will differentiate supplier"s costs. However, at this point there is not a wealth of data available that would indicate how the market would differentiate pricing in order to serve different types of customers that will be receiving Default Service. In accounting for the costs related to generation supply (as opposed to the other costs incurred by the distribution company in order to provide the service or transitional mechanisms that are being proposed to the Department prior to full implementation of its Default Service rules) the Department should avoid seeking to administratively determine whether the costs associated with default supply differ among customer classes. Rather, it would be more appropriate to allow the market forces to provide the answer.

There is no statutory or regulatory prohibition against structuring default service pricing to account for differences in costs to serve different rate classes. G.L. Ch. 164 "1B(d), 220 CMR "11.04 (9)(c)2. DOER believes the critical question is whether Default Service pricing can meet the statutory requirement that prices accurately reflect the market without differentiating customer classes? We believe that it cannot. That is, we believe that Default Service must be differentiated by class to achieve the equivalent of "an average monthly market price" as required by the Act. We would point out that a number of states that have moved to competition have structured their utility equivalents of Default Service rates to reflect differentiated pricing based on customer class. In the few instances where customer classes have been bid discreetly, they have produced different prices to supply different customer groups. Allowing suppliers to bid for loads discreetly will allow them to reflect the appropriate costs and level of risks in the prices they charge to supply Default Service to the customer.

By contrast, requiring Default Service suppliers to provide an average price to serve all customer classes will lead to cross-subsidization between classes. Customers within classes that exhibit relatively low risk profiles would see higher than appropriate prices for their Default Service. Customers within classes that exhibit relatively high-risk

profiles would see lower than appropriate prices for their Default Service. There are clear equity issues related to imposing on one customer class the cost of another. Moreover, this may cause affected customers to choose service from competitive suppliers who might appear to offer a good value relative to the Default Service rate, but in fact are pricing their generation service at a level higher than their costs and risks in a competitive market would otherwise allow. Conversely, competitive suppliers may ignore customers who could be attracted by products that would offer them value at a fair price, but cannot be approached because a below-cost regulated rate encourages them to remain on Default Service. Artificially imposing a single rate across all customer classes can thus obscure price signals that customers need in order to make informed, efficient choices in a competitive market.

Some interested parties have expressed the concern that solicitations based on customer class will result in overall higher prices simply because the larger combined load may be more attractive for wholesalers to serve. There is no evidence to support this view, but given the large number of customer rate classes, some degree of aggregation to achieve administrative efficiency in the procurement of supply is warranted.

DOER recommends that, at least for now, customer classes be grouped into two or no more than three broad "blocks" (e.g. residential/small commercial, medium sized commercial/industrial and large industrial customers) in order to make procurements efficient while still reflecting differences in cost to serve these groups. Allowing the possibility of a single bidder to supply all three rate classes (at separately bid prices) will minimize the risk that separating the load into distinct blocks will put upward pressure on prices. DOER believes it is unlikely that any such upward price pressure will be significant relative to the importance of reflecting the underlying cost differentials between classes

**Question 4 (Part a): If a distribution company"s overhead and administrative costs associated with providing default service were to be included in the price for default service paid by customers, how should these costs be estimated?**

In its May 12 Order in D.T.E. 99-60-A, the Department addressed the retail price components of a default service rate. The Department correctly observed that the inclusion of all costs incurred by a distribution company in providing default service is essential to the development of a default service rate that provides an appropriate price signal to customers and allows competitive suppliers a fair opportunity to compete for default service customers.

DOER agrees with the conceptual framework that the Department has adopted. DOER has indicated that it would be appropriate to include all of the costs that a distribution company incurs in making default service available to its customers. Such action sends an

appropriate price signal to customers as they consider whether to choose to receive generation service from an alternate supplier. However, it is important to recognize at the outset that there is no "right" answer regarding the level of "avoidable" costs to include in the default service rate. Instead, the issue is largely one of policy. The avoidable costs could be set at a "decremental" level, consistent with the costs that would be avoided if a single customer were to choose to receive service from a competitive generation supplier. Alternately, avoidable costs could be set a level consistent with many or all default service customers choosing alternate suppliers.

DOER recommends that the Department direct the distribution companies to make filings that present estimates of their avoidable costs, giving due consideration to the full range of accounts that might contain costs that would be avoided as shopping occurs. This information can be used to establish rates for default service that reasonably reflect the real costs that providing the service imposes on distribution utilities.

**Question 4 (Part b): Can these [i.e., the overhead and administrative costs of providing default service] be quantified only in the course of a rate proceeding?**

DOER offers three comments in response to this question. First, a priority should be placed on establishing default service rates that properly reflect the full costs of the service. DOER recommends adopting an approach to pricing default service that will reflect the full costs of the service in rates while deferring to an appropriate time and proceeding questions regarding whether a company"s base rates for distribution services are just and reasonable. As is suggested by DOER"s response to Question 1, if an efficient competitive market is to be established in Massachusetts, it is essential that the generation services offered by distribution companies be priced at levels that reflect the full cost that the company incurs in providing the service as soon as possible and not delayed until the conclusion of the distribution companies next rate case.

Second, there is no reason why quantification of the various costs of providing default service cannot be performed immediately. Given a policy decision by the Department regarding how the avoidable costs are to be defined, an inquiry regarding the level of administrative and other costs that a distribution company should properly include in its default service rate can be pursued at least as readily outside of a base rate proceeding as in one.

Third, DOER recommends that the questions of whether and how to adjust base rates to remove any costs related to default service, can and should be set aside for the present. A decision as to whether to initiate a base rate proceeding should result from consideration of a range of factors extending well beyond the level of costs related to the provision of default service that currently reside in base rates. Such factors to be considered include the terms of any Department-approved rate plans and a host of other costs that would affect a company"s revenue requirements. The far reaching question of whether and when

to initiate base rate proceedings for electric distribution companies should not be driven by the need to set reasonable default service rates.

DOER recognizes that implementation of default service pricing to incorporate all costs that a distribution company might avoid as customers choose to receive generation supplies from competitive suppliers may lead to rates that exceed the costs incurred by distribution companies to procure default service generation supplies. To the extent that this occurs, it may be appropriate to ensure that distribution companies do not reap excess profits. DOER's proposed credit mechanism would operate as follows. Default service rates would be reviewed and approved by the Department prior to implementation. In establishing the default service rate for a given service interval, the Department would consider (1) the direct and indirect costs proposed by the distribution company for inclusion in the default service rate and (2) the amount of the credit to built into rates prospectively to ensure that the distribution company remains revenue neutral in providing the service.

The credit, which would be periodically adjusted to reconcile default service revenues to actual costs, would serve to return to customers the net of default service revenues less the direct costs of default service and any other new and additional costs that the Department has approved for inclusion in the default service rate. The credit would be preserved for default service customers who choose to receive generation service from competitive suppliers, so as not to undermine the price signal that would otherwise be created through a default service rate that includes the real costs of the service (i.e., the costs that a distribution company can avoid if a customer shops, as defined by the Department). For ease of administration, it may be best to spread the credit across all customers within a given distribution rate class.

DOER notes that if (1) the level of costs related to default service that currently reside in distribution rates is found to be relatively large (i.e., in terms of their per kWh impact on the default service rate), and (2) the amount of the credit received by default service customers is relatively small, then questions may arise as to whether default service customers would be overcharged in some appreciable way through the pricing and credit mechanisms that DOER is proposing. We observe that under our proposal default service customers would (1) pay the current distribution rates as have been approved by the Department, (2) pay the full amount of any costs that default service imposes on a distribution company, and (3) receive a small credit on the distribution rates. Other customers would be unaffected, but for those that also receive the credit, as necessary to preserve price signals and avoid windfalls to distribution companies.

Based on the foregoing, DOER concludes that no overcharge of default service customers would result under its proposal. It is true that default service rates (and thus total charges to default service customers) would be lower if set at a level that ignores any related costs that currently reside in distribution rates. However, DOER submits that the default service rate will become the threshold price that defines the degree to which a competitive retail market unfolds in Massachusetts. Given a choice between artificially suppressing rates for default service to levels below cost or changing a rate that more

closely approximates the and exposing to competitors the full level of those costs, DOER prefers the latter.

**Question 7: Please discuss in specific detail what function, if any, the Department should have in overseeing default service procurement.**

The Department"s proposal for default service, as described in the May 12 Order, would leave considerable discretion to the distribution companies to administer supply solicitations. DOER is concerned that there are two significant problems with this approach. The first results from the fact that the default service framework is likely to introduce little by way of incentives to ensure that the distribution companies procure power supplies to serve default service customers at the lowest prices possible consistent with the terms of default service. Consumers could thus be at risk for paying higher default service rates than necessary. The second relates to the fact that the history of electric company supply solicitations in Massachusetts includes a number of instances in which legitimate disputes have arisen between participants. Legal action to resolve possible future disputes may present significant risk to ratepayers to the extent that such disputes threaten to delay default service supply procurements at times when market prices are high. A modest degree of Department oversight in default service supply solicitation processes would do much to mitigate the risks that consumers might otherwise face.

DOER believes that there are steps that the Department can take to oversee solicitation processes that would represent a minimal intrusion on market processes, but would substantially improve the chances that the results will benefit customers. Standardization of the solicitation process across distribution companies is likely to offer benefits to the distribution companies, default service generation suppliers, and customers. It will be easier for bidders to participate in default service supply solicitations and fewer costs will be imposed on them to the extent that the requests for proposals and language contained in supply contracts is the same across distribution companies. While imposing an identical approach on all distribution companies is not practical, neither is it necessary for each to have a very different approach to procuring and securing default service supplies.

DOER believes that the Department should not take on the burden of constructing a standard solicitation package (i.e., RFP and contract) " that process is best left to a collaborative effort among industry stakeholders. However, the Department should (1) review and approve (as appropriate) the results of solicitations; and (2) expect that distribution companies will implement a standard Department approved solicitation unless they can demonstrate a reason to deviate from it. Such an approach will remove uncertainties for suppliers in early bid processes, and accelerate the rate at which these solicitations become routine (and thus less costly) for all.

DOER believes that Department review of proposed solicitations, with an opportunity for stakeholders to comment on a proposal, can do much to limit the risk of post-solicitation

disputes. Clearly, as default service supply solicitations become routine, the time required by and intensity of review will diminish. DOER anticipates that eventually default service supply RFPs and contracts will receive perfunctory approval, absent identification of some significant problem.

Department review should seek to achieve several objectives. First, it should create an opportunity for potential bidders and other stakeholders to identify problems in a solicitation process before an RFP is issued and the pressure mounts to establish rates for a "new" default service package as the expiration date for the "old" approaches. Second, the Department should ensure that any solicitations are arm"s length in nature. That is, a distribution company and its affiliates should not have a stake in the outcome of its RFP. DOER notes that this should not be a problem for most of the distribution companies, since most are fully divested of their generation resources.

Third, default service supply costs will be minimized to the extent that the time between when bids are submitted and when delivery of a default service generation supply would begin is also minimized. Therefore, the Department should act to ensure that solicitation processes are as streamlined as possible. This can be accomplished by the pre-qualification of bidders and standardization of contract language and bid documents. The initial solicitations may require a greater degree of Department review, but once the Department is satisfied with a process that is largely standardized, then only limited oversight would be expected to be necessary. DOER"s thoughts on an illustrative timeline for the solicitation that would accommodate Department review on an "as necessary" basis are attached as Appendix I.

Fourth, the Department should review the schedule for the timing of the default service bids across the companies. If all utility solicitations are simultaneous, (e.g., January and June), then a losing bidder will have to wait at least six months for the next round. If solicitations occur and are evenly distributed throughout the year, this will help to minimize supply costs and help the competitive market to develop.

## APPENDIX 1 -- DEFAULT SERVICE:

## REGULATORY REVIEW

(5/31/00)

**Illustrative Regulatory Review Timeline:**

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| TBD Before Start of The First Service Interval | Distribution companies file proposed Standard DS Generation Supply RFP and Standard DS Generation Supply Contract with the Department for review and comment. |
| 90 Days Before Start of Service Interval | Distribution company files for review by Department its proposed (1) Standard DS Generation Supply RFP prescribing method by which bids will be evaluated, (2) Standard DS Generation Supply Contract, (3) proposed per kWh direct costs to be recovered through the DS Rate, (4) proposed per kWh indirect costs to be included in the DS Rate, and (5) the estimated DS rate that will result (Item 5 may be only a "best guess" for the first solicitation).<br><br>Company issues public notice to potential DS Generation Suppliers, including information regarding locating its filing to the Department on its website. |
| 60 Days Before Start of Service Interval | Distribution Company filing receives "automatic" approval, absent action by the Department to initiate a formal review. |
| 45 Days Before Start of Service Interval | Distribution Company issues DS generation supply RFP. |
| 35 Days Before Start of Service Interval | Bids from DS Generation Suppliers are due. |
| 30 Days Before Start of Service Interval | Distribution company files new DS Rates with the Department for review and approval. |
| | Distribution company provides notice to customers of pending change to DS rates. |
| 20 Days Before Start of Service Interval | Distribution company"s DS Rates are automatically approved, unless the Department initiates a formal review. |
| Day 1 of Service Interval | New DS Rates take effect. |
| Day 150 of Service Interval | Distribution company"s next DS Rate filing includes cost true-up that identifies actual direct costs (beyond those of the DS generation supply) for which cost recovery is requested from DS Rate revenues. The amount of the next service interval"s credit to customers would be adjusted accordingly. |
| Day 90 of Service Interval | See # 2 above. |